

1997

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# The Modern Law of Securities in the People's Republic Of China

## **Abstract**

[extract] The PRC Law of Securities was enacted to promote financing and circulation of commodities, safeguard fulfillment of obligations and advance the development of the socialist market economy (Art 1). The Law is divided into seven chapters consisting of 96 articles. It clearly distinguishes a mortgage from a pledge and regards them as two different types of security interests. The forms of security interests provided for in the Law are guarantee, mortgage, pledge, lien and deposit (Art 2).

The aim of this paper is to discuss some of the salient features of the security interests provided for in the Law. Reference will also be made to provisions in other relevant legislation recently promulgated in China.

## **Keywords**

People's Republic Of China, securities, Law of Securities

# THE MODERN LAW OF SECURITIES IN THE PEOPLE'S REPUBLIC OF CHINA

by  
**Clement Shum\***

## **Introduction**

Article 89 of the General Principles of Civil Law of the People's Republic of China<sup>1</sup>(GPCL) sets out four types of security interests: guarantee, pledge, deposit and lien. It provides as follows:

In accordance with the provisions of the law<sup>2</sup> or the agreement of the parties, the following means may be adopted to assure the performance of obligations:

1. Where a guarantor guarantees to the obligee that the obligor will perform the obligation and the obligor does not perform, the guarantor should according to the agreement perform the obligation or bear the [sic] joint liabilities; after the guarantor performs the obligation, he is entitled to seek compensation from the obligor.
2. An obligor or third party may offer certain property as a pledge.<sup>3</sup> Where the obligor does not perform the obligation, the obligee is entitled in accordance with the provisions of law to evaluate the pledged<sup>4</sup> property in term of money and credit it against the obligation, or sell the pledged<sup>5</sup> property and obtain compensation by priority right [sic] from the proceeds.
3. A party may within the limit provided by law give the other party a deposit. After the obligor performs the obligation, the deposit must be deducted from the price or returned. Where the party who gave the deposit did not perform the obligation, he did not have the right to request the return of the deposit; if the party who received the

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1 Adopted on 12 April 1986 at the 4th session of the 6th National People's Congress. It came into effect on 1 January 1987. For an English translation of the GPCL (on which this article relies), see *Collection of Laws and Regulations of the PRC Concerning Foreign Economic Affairs*, vol 6, 58-90, edited by The Department of Treaties and Law of the Ministry of Foreign Economic Relations and Trade of the PRC, Publishing House of Law (Beijing) 1987.

2 At that time there was no specific legislation governing security interests, apart from Article 89 of the GPCL.

3 It seems that the appropriate English translation should be 'mortgage' and not 'pledge'.

4 It seems that the appropriate English translation should be 'mortgaged' and not 'pledged'.

5 See 4 above.

deposit did not perform the obligation, he must return twice the amount of the deposit.<sup>6</sup>

4. Where one party is in possession of the property of the other pursuant to contract provisions, the possessor may, if the other party fails to pay within the agreed time what he is obligated to pay, retain the property, and in accordance with provisions of the law evaluate the retained property in terms of money or sell the retained property and obtain compensation by priority right [sic] from the proceeds.<sup>7</sup>

It should be noted that the GPCL does not distinguish a pledge from a mortgage and the term 'pledge' used in Article 89 includes 'mortgage'. Thus, the subject matter of the pledge can be real property, or personal property.<sup>8</sup>

Article 89 of the GPCL simply sets out some basic principles relating to guarantee, pledge, deposit and lien and there are no detailed provisions about them. It does not deal with the following questions.<sup>9</sup>

1. Who is legally competent to provide securities?
2. What kinds of property may become the subject matter of a pledge, mortgage or lien ?
3. What are the rights and duties of the parties to the security contract?
4. What is the proper procedure for creating a security interest?

In 1992, the Legislative Affairs Commission of the National People's Congress began to draft the PRC Law of Securities. The Commission consulted relevant government departments, the people's courts, legal experts, and referred to the laws of other countries and international practice.<sup>10</sup> The PRC Law of Securities (the Law) was adopted at the 14th session of the Standing Committee of the 8th National People's Congress and promulgated on 30 June 1995.<sup>11</sup> It came into effect on 1 October 1995.

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6 There are similar provisions in Art 14 of the Economic Contract Law of the PRC (ECL) promulgated at the 4th session of the 5th National People's Congress on 13 December 1981. The ECL was amended on 2 September 1993. See *China Law & Practice*, 18 November 1993, 40-48.

7 For an explanation of Art 89, see Opinion (For Trial Use) of the Supreme People's Court on Questions Concerning the Implementation of the GPCL, paras 106-117. For an English translation of the Opinion, see *Law and Contemporary Problems*, vol 52, 2, 59-87.

8 See '*The Study of Civil Law*', China University of Political Science and Law Press (Beijing) 1994, 309.

9 See the Explanation to the draft PRC Law of Securities, reproduced in the Annotated PRC Law of Securities (in Chinese) edited by the Legislative Affairs Commission (Office of the Civil Law) 123-127, Publishing House of Law (Beijing) 1995.

10 See 9 above, 123-4.

11 For an English translation of and brief comment on the Law, see *China Law & Practice*, 11 August 1995, 21-44. See also CCH *China Laws for Foreign Business-Business Regulation* ¶5-605.

Undoubtedly, the PRC Law of Securities is an extremely important piece of legislation promulgated at a time when China has been moving away from the 'planned commodity economy' to the 'socialist market economy'. This is a relatively new concept<sup>12</sup> which provides some justification for China to

boldly learn and borrow from the legislative experience of the economically advanced nations of the west...because such experience belongs to the common heritage of human civilization, and the globalization of economic activities requires Chinese law on trade and investment to be compatible with foreign and international practice.<sup>13</sup>

The PRC Law of Securities was enacted to promote financing and circulation of commodities, safeguard fulfillment of obligations and advance the development of the socialist market economy (Art 1). The Law is divided into seven chapters<sup>14</sup> consisting of 96 articles. It clearly distinguishes a mortgage from a pledge and regards them as two different types of security interests. The forms of security interests provided for in the Law are guarantee, mortgage, pledge, lien and deposit (Art 2).

The aim of this paper is to discuss some of the salient features of the security interests provided for in the Law. Reference will also be made to provisions in other relevant legislation recently promulgated in China.

It should be noted that the PRC Law of Securities is not the *only* legislation that governs the provision of securities. There is other legislation which has been enacted recently to regulate particular transactions. For example, secured loans provided to borrowers by Chinese-invested commercial banks, trust and investment companies and other financial institutions are governed by the Lending General Provisions (Trial Implementation), promulgated by the People's Bank of China on 27 July 1995;<sup>15</sup> and provision of securities to foreign entities outside China, or foreign-invested financial institutions within China, by domestic institutions inside China, is regulated by the Administration of the Provision of Securities to Foreign Entities by Domestic Institutions Inside China Procedures, promulgated by the People's Bank on 25 September 1996 and effective as of 1 October 1996.<sup>16</sup>

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12 See *Wang & Wei Legal Developments in China: Market Economy and Law*, (eds.) Sweet & Maxwell 1996, 3-20.

13 See 12 above, at 4, which summarises the various speeches made in 1993 by Mr Qiao Shi, Chairman of the Standing Committee of the National People's Congress.

14 Chapter 1 on general provisions; chapter 2 on guarantee; chapter 3 on mortgage; chapter 4 on pledge; chapter 5 on lien; chapter 6 on deposit and chapter 7 on supplementary provisions.

15 For an English translation of, and brief comment on, the Lending General Provisions (Trial Implementation), see *China Law & Practice*, 1 November 1995, 35-56.

16 For an English translation of the Administration of the Provision of Securities to Foreign Entities by Domestic Institutions Inside China Procedures, see *China Law & Practice*, Dec96/Jan 97, 43-48.

## Definition Of Security

The term 'security' is not defined in the Law. But it is obvious that 'security' embraces a guarantee provided to an obligee by a third party known as the guarantor (Art 6). It also includes a third party mortgage (Art 33), a third party pledge (Art 63), or a deposit paid by one party to the other party as a security (Art 89). Thus it seems that in Chinese law a security or a security interest may be defined as:

1. An interest vested in an obligee in certain property owned by the obligor or a third party, whereby certain rights are made available to the obligee over such property in order to satisfy an obligation owed to the obligee by the obligor;<sup>17</sup> or
2. A guarantee whereby a guarantor and an obligee agree that if the obligor fails to perform his obligation, the guarantor will perform the obligation or assume liability (Art 6); or
3. A deposit paid by one party to the other party as a security for an obligation (Art 89).

Thus, a 'secured loan' may mean:

1. A guaranteed loan, ie, a loan granted by the lender on the condition that a third party will undertake to bear guarantee liability if the borrower fails to repay the loan;
2. A mortgaged loan, ie, a loan granted by the lender against the property of the borrower or a third party;
3. A pledged loan, ie, a loan granted by the lender against a movable property or a property right of the borrower or of a third party as a pledged item.<sup>18</sup>

## Scope of Applicability and of Security

The Law applies to *economic activities* such as lending, sale of goods, carriage of goods and contracted processing (Art 2); but where laws (eg, the Maritime Law) have special stipulations relating to securities, those special stipulations should be complied with and the PRC Law of Securities

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17 This proposed definition is based on the definition of a security in Sykes and Walker, 'The Law of Securities', 5th edition, The Law Book Co, 1993, at 12, where a security is defined as an interest vested in the creditor in certain property owned by the debtor, whereby certain rights are made available to the creditor over such property in order to satisfy an obligation personally owed or recognised as being owed to the creditor by the debtor or some other person.

18 See Art 11 of the Lending General Provisions (Trial Implementation), promulgated by the People's Bank of China on, and effective as of, 27 July 1995. For an English translation of the Provisions, see *China Law and Practice*, 1 November 1995, 35-53.

will not apply (Art 95).<sup>19</sup> Thus, the principal or underlying contract must be an *economic contract*, which aims to realise a definite economic objective.<sup>20</sup> The contract of guarantee, mortgage, pledge, or deposit is an ancillary contract, which may be a separately concluded written agreement (including an agreement which may be contained in correspondence or facsimile), or a clause (providing for securities) in the principal contract (Art 93).

Economic contracts in China include construction contracts, processing contracts, contracts for the carriage of goods, contracts for the lease of property, loan contracts, insurance contracts, contracts for the supply and use of electricity, and contracts for storage and safekeeping.

A security contract is an ancillary contract to the principal contract. If the principal contract is void, the security contract is also void, unless the security contract provides otherwise (Art 5, para 1). The Law also provides that if a security contract is not valid and the obligor, obligee or the security provider is at fault,<sup>21</sup> that person shall bear civil liability commensurate with his fault (Art 5, 2nd para).<sup>22</sup>

A third party that provides a security to an obligee may require the obligor to provide a counter-security. The Law also applies to all the counter-securities provided by the obligor (Art 4).

Subject to the provisions in the contract, the amount secured should include the principal debt, interest, breach of contract damages, compensation damages and expenses incurred in realising the obligations; and in the case of a pledge or lien, additional custody expenses (Arts 21, 46, 67 & 83).

### Basic Principles

Article 4 of the Law sets out general principles relating to the provision of securities. Activities relating to the provision of securities

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19 The Maritime Code of the PRC was adopted at the 28th session of the Standing Committee of the 7th National People's Congress on 7 November 1992. It came into effect on 1 July 1993. There are provisions in the Maritime Code relating to securities (e.g. Section 2 on Mortgage of Ships). For an English translation of the The Maritime Code, see Maritime Code of the PRC, Publishing House of Law (Beijing) 1993.

20 See Art 2 of the Economic Contract Law of the PRC (ECL), adopted and promulgated at the 4th session of the 5th National People's Congress on 13 December 1981. The ECL was amended at the 3rd session of the Standing Committee of the 8th National People's Congress on 2 September 1993. For an English translation of the ECL, see China's Foreign Economic Legislation vol 2, Foreign Languages Press (Beijing) 1986, 1-27. For the 1993 amendment, see China Law & Practice, 18 November 1993, 40-48.

21 There is no definition of 'fault' in the Law. But the Supreme People's Court was of the opinion that to constitute 'fault' there must be non-performance or incomplete performance of the obligations stipulated in the contract because of a deliberate act or negligence of a party. See '*Opinions of the Supreme People's Court on Questions Concerning the Implementation of the Economic Contract Law*' (17 September 1984) in China Law Yearbook 1987, Butterworths, 407-412 at 410.

22 See also Art 61 GPCL which provides, among other things, that after a civil act is confirmed to be void, a party must return the property acquired as a result of the act to the party who suffered the loss. A party who was at fault must compensate the other party for the loss caused thereby. Where both parties were at fault, they must bear their own liabilities respectively.

should conform to the principles of equality, voluntariness, fairness, honesty and good faith (Art 3).<sup>23</sup>

The provision of securities is a civil legal act and is therefore governed by the GPCL, which regulates property relations and personal relations between subjects of equal status--between citizens, between legal persons, and between citizens and legal persons (Art 2 GPCL). The principles of 'equality' include the following:

1. The parties are equal in status when entering into a contractual relationship. No party can be forced to enter into a contract or to accept contractual terms which are not fair.
2. The parties are equal in status when performing their respective obligations under a contract, and they should not rescind or vary the contract unilaterally. A party that breaches the contract should bear responsibility.<sup>24</sup>

'Voluntariness' means that the parties have a real intention to enter into a legally binding agreement.<sup>25</sup> 'Fairness' implies that everyone is given an opportunity to compete for the contract, and that if, due to the fault of one party, the contract cannot be performed or cannot be fully performed, the party at fault shall be liable for breach of the contract; if both parties are at fault, each party shall be commensurately liable for the breach of the contract.<sup>26</sup>

The concept of 'honesty and good faith' originates in the civil law system. 'Honesty and good faith' has to be shown not only in the pre-contractual negotiations, but also in the performance of the contract. Chinese contract law follows closely the civil law concept.<sup>27</sup> 'Honesty and good faith' embraces the following principles:<sup>28</sup>

1. A party to a contract should not commit any dishonest act to induce the other party to enter into the contract. Dishonest acts include misrepresentation and concealment of material facts.
2. During the performance of the contract, a party who cannot perform his obligations under the contract as a result of force majeure should inform the other party promptly to minimise loss, if any. Unless the law provides otherwise, if a party wants to vary or cancel the

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23 Cf Art 4 of the GPCL, which provides that civil activities must be carried out in accordance with the principles of voluntariness, fairness, *exchange of equivalent values*, honesty and good faith.

24 Handbook of Chinese Contract, Economics & Management Publishing House (Beijing) 1991, p19.

25 Art 55 GPCL provides that a civil legal act must satisfy the following conditions: 1. The person performing the act has the appropriate competence. 2. The real intent is expressed. 3. There is no violation of the law, and of social and public interest.

26 See 24 above, 20. See also Art 29 ECL.

27 See Nicholas B, *The French Law of Contract*, (2nd ed) Clarendon Press Oxford 1992, 48, 71, 153-4.

28 See 24 above, 21-22.

contract, he should consult the other party first and obtain the other party's consent.

3. If the terms of the contract are not clear, they should be interpreted on the basis of honesty and good faith. No party should deliberately twist the meaning of a contractual term.
4. The contract should not contain any term that will restrict competition and maintain monopoly.<sup>29</sup>
5. Performance of the obligations under the contract should be based on the principle of honesty and good faith.
6. An arbitral organ or a people's court should adjudicate contractual disputes on the basis of honesty and good faith.

In addition, Article 4 of the GPCL requires that civil activities must be carried out in accordance with the principle of exchange of equivalent values. A salient feature of the planned economy was that production and exchange of commodities by governmental units was determined by the central government, which also decided the value of the commodities. Under the planned economy contracts were administrative orders. The passing of property in the goods from one unit to another was based on an exchange of goods of equivalent value. It was believed that this would guarantee the lawful benefits of the parties.<sup>30</sup> But China amended its constitution in 1993.<sup>31</sup> Article 15 of the Constitution now provides that 'the State practises a socialist market economy. The State strengthens economic legislation and perfects macro-level regulation and control.'<sup>32</sup> There are different interpretations of the term 'socialist market economy'.<sup>33</sup> Recent legislation promulgated after 1993 does not require that civil activities be carried out in accordance with the principle of 'exchange of equivalent values'.<sup>34</sup>

## Guarantee

### Definition

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29 Cf Art 35 PRC Technology Contract Law, adopted at the 21st session of the Standing Committee of the 6th National People's Congress on 23 June 1987. For an English translation of the PRC Technology Contract Law, see Cohen A, *Contract Laws of the PRC*, Longman 1988, 150-158. Art 35 provides that technology transfer contracts may stipulate the scope of exploitation of patents or the use of non-patented technology by the transferor or the transferee, provided that contractual clauses shall not be employed to restrict technological competition and technological development.

30 See *Encyclopedia of Chinese Economic Law*, Publishing House of Law (Beijing) 1991, 554-5.

31 On 29 March 1993, the 8th National People's Congress adopted a set of amendments to the 1982 Constitution. See 'Hong Kong Law Journal', vol 23, no 2, 224-229.

32 Prior to the amendment, the article read: 'The State practises economic planning on the basis of socialist public ownership. The State ensures the proportionate and co-ordinated development of the national economy through overall balancing by economic planning and the supplementary role of market regulation. Disruption of the socialist economic order or undermining of the State economic plan by any organization or individual is prohibited.'

33 See 12 above.

34 See, for example, the amendment to the 1981 ECL, and the PRC Law of Securities.

A guarantee is created when a guarantor and an obligee agree that when the obligor does not perform his obligations, the guarantor shall perform the obligations or assume liability as agreed (Art 6).

Unlike the common law, the PRC Law of Securities does not distinguish a guarantee from an indemnity. But the Law sets out two forms of guarantee: general guarantee and guarantee with joint and several liability (Art 16). Under a general guarantee, the guarantor is not liable unless the obligee has taken legal action and subsequently obtained an enforcement order against the obligor's property (Art 17)<sup>35</sup> and the judgment remains unsatisfied. A guarantee with joint and several liability is not conditional on the obligee obtaining a judgment or an arbitral award against the obligor; if the obligor fails to perform his obligations under the principal contract, the obligee may require the guarantor to perform the obligations or assume guarantee liability (Art 18). Article 18 provides that if the parties have not agreed on the form of the guarantee, or if the provisions in the contract are ambiguous, the guarantee will be regarded as a guarantee with joint and several liability.

## **Form and Content of Guarantee**

A guarantee contract must be in writing and should contain the following terms:<sup>36</sup>

1. The type of obligation and the amount of the principal debt guaranteed: The type of obligation refers to the nature of the underlying contract, which may be a contract for services, a loan agreement or a contract for sale of goods. The guarantee may cover a single transaction, or a series of transactions between the obligor and the obligee over a certain period of time, but subject to a maximum debt amount (Art14).
2. The time limit for the obligor to perform his obligations.
3. The form of the guarantee: The guarantee may be a general guarantee or a guarantee with joint and several liability (Art 16).
4. The scope of the guarantee: Subject to the provisions in the contract, the amount guaranteed should include the principal debt, interest, breach of contract damages,<sup>37</sup> compensation damages and expenses

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35 Art 17 lists three exceptional circumstances under which the obligee can look to the guarantor for payment without first suing the obligor. First, where the obligor has changed his residence, which makes it extremely difficult for the obligee to request the obligor to perform his obligation. Secondly, an application for bankruptcy of the obligor has been accepted by a people's court and the execution process has been suspended. Thirdly, the guarantor has waived his rights under Art 17 in writing.

36 See Art 13 & Art 15 of the Law.

37 Art 31 of the ECL provides: If a party breaches an economic contract, it shall pay breach of contract damages to the other party. If the breach of contract has already caused the other party to suffer

incurred in realising the obligation. If the parties have no agreement on the scope of the guarantee or if its scope is unclear, the guarantor shall be responsible for the entire obligation (Art 21). Where the same obligation is guaranteed by two or more than two guarantors, the guarantors shall share their liability according to the contract. Where the contract does not provide for their respective shares of their liability, the guarantors shall bear joint and several liability (Art 12). Where the obligation is secured by a guarantee as well as property under the mortgage, pledge or lien, the guarantor's liability is confined to that which is not secured by the property, even if the obligee subsequently gives up the property as a security (Art 28). If the obligee transfers his rights under the guarantee to a third party during the currency of the contract, the guarantor shall continue to bear guarantee liability within the scope of the original guarantee, unless the guarantee contract provides otherwise (Art 22).

5. The duration of the guarantee: Subject to the provisions in the contract, the duration of a guarantee is six months following the date of expiration of the term for performance of the principal obligations (Arts 25 & 26). If the guarantee covers a series of transactions subject to a maximum debt amount, and there are no provisions as to the duration of the guarantee, the guarantor may at any time give notice to the obligee to terminate the contract. However, the guarantor shall be responsible for the obligations incurred before the obligee is notified (Art 27).
6. Other matters that the parties consider necessary to be included in the contract.

There are no provisions in the Law which oblige the obligee to provide a copy of the principal contract to the obligor before the obligations under the principal contract are secured by a guarantee, nor are there provisions to the effect that the guarantor be given a copy of the guarantee signed by him.

### **Who can become Guarantors**

Not everyone can become a guarantor. A guarantor must be a person with full competence to perform civil acts; he must be aged 18 or over, or a person between 16 and 18 whose principal source of support is income from his own labour.<sup>38</sup> A person suffering from mental illness who is unable to understand the propriety of his own acts is not legally incompetent.<sup>39</sup> In addition, Article 7 of the Law provides that 'legal persons, other organisations or citizens that are able to fulfil the obligations of an obligor may act as guarantors.' The Law does not provide any guidelines for

losses that exceed the amount of the breach of contract damages, the breaching party shall pay compensation and supplement the breach of contract damages by the insufficient amount. If the other party demands continued performance of the contract, the breaching party shall continue to perform.

38 Art 11 GPCL.

39 Art 13 GPCL.

determining the ability of a potential guarantor to fulfil the obligations of the obligor. Presumably, his ability must be judged at the time of the contract and with reference to his total assets minus his total liabilities. But a guarantor that is financially sound at the time of the contract may run into financial difficulties at the time when he is asked by the obligee to perform the obligations of the obligor. Thus, it appears that Article 7 does not set out the pre-requisites for the validity of the guarantee contract. But an obligee should investigate the financial position of the potential guarantor before accepting his guarantee. It seems that the guarantee contract will not be declared void simply because it is proved that at the time of the contract the guarantor is not capable of fulfilling the obligations of the obligor.

The following cannot act as guarantors:

1. State organs: State organs cannot act as guarantors, except where a loan from foreign governments or international economic organisations are used for on-lending as a sub-loan with the approval of the State Council (Art 8). This type of loan is often used to finance important projects and is guaranteed by ministries responsible for finance, or planning and management under the State Council.
2. Institutions and associations that provide public services, such as schools, kindergartens, hospitals, etc may not act as guarantors (Art 9).
3. The branch office or a department of an enterprise legal person cannot act as a guarantor. But a branch office may act as a guarantor if it is authorised by the enterprise legal person (Art 10). If a branch office enters into a contract of guarantee without the written authority from the enterprise legal person, the contract is void. If a branch office exceeds its authority, that part of the contract which the agent has no authority to enter into, is void. A guarantee contract which is wholly or partially void is not without any legal effect; the obligee or the enterprise legal person that is at fault has to bear civil liability according to the extent of the fault. Where the obligee is not at fault, the enterprise legal person itself will bear civil liability (Art 29).

### **Guarantor's Rights**

1. In the case of a general guarantee, if the obligor defaults, the guarantor may request the obligee to sue the obligor and to execute any judgment against the obligor's assets (Art 17).
2. The guarantor, on being sued by the obligee, can rely on any defence, set-off or counter-claim available to the obligor against the obligee (Art 20).

3. On payment of what is due under the guarantee, a guarantor is entitled to be compensated by the obligor (Art 31), or to an appropriate contribution from other co-guarantors in the case of a guarantee with joint and several liability (Art 12).
4. The guarantor's written consent is required for any variation of the principal contract, unless the guarantee contract provides otherwise (Art 24).
5. The guarantor's written consent is required if the obligor transfers his obligations to another person, even with the consent of the obligee (Art 23).
6. If the obligor becomes bankrupt and the obligee does not lodge any claim against the bankrupt obligor, the guarantor is entitled to participate in the distribution of the obligor's property. This will enable the guarantor to exercise his right of compensation against the obligor in advance (Art 32).

There are no provisions in the Law enabling a guarantor to be subrogated to all the rights of the obligee in respect of the obligations to which the guarantee relates.

### **Discharge of the Guarantor**

The guarantor shall assume no civil liability in the following situations (Art 31):

1. The parties to the principal contract conspire with each other to deceive the guarantor into providing the guarantee.
2. The obligee obtains the guarantee by fraud or duress, etc. and the guarantee is provided against the guarantor's real intention (Art 31).

### **Mortgage**

#### **Definition**

A mortgage is created when an obligor or a third party, without transferring possession, uses his property as security for the fulfilment of the obligations under the principal contract. When the obligor does not fulfil his obligations, the obligee is entitled to convert the mortgaged property to value, to auction or to sell the property.<sup>40</sup> Thus, under a

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40 Cf Art 46 PRC Administration of Urban Real Property Law (Urban Real Property Law) adopted at the 8th session of the 8th National People's Congress, promulgated on 5 July 1994 and effective from 1 January 1995 (For an English translation of the Urban Real Property Law, see *China Law & Practice*, 3 October 1994, pp23-38); The term 'mortgage of real property' shall refer to an act where a mortgagor provides a mortgagee with a security for the performance of his obligations by means of his lawful real property without transferring the possession of such property. When an obligor fails

mortgage the mortgagee's right is a right in and enforceable against the property of the mortgagor or a third party, whereas the right of the obligee under a guarantee is a right against the guarantor. In other words, a mortgage is a 'property' security and a guarantee is a 'personal' security. The mortgage provides the mortgagee with certain rights exercisable against the mortgaged property itself; and it does not involve a transfer of legal ownership or possession of the mortgaged property to the mortgagee.

## Differences Between Guarantee and Mortgage

A Chinese text<sup>41</sup> explains the differences between a guarantee and a mortgage as follows:

1. A mortgage right is a 'property right'.<sup>42</sup> An obligee who is given the property right is guaranteed performance of the obligations under the principal contract by the security of a specific thing. A guarantee is a right to have the obligations performed and the guarantor guarantees performance of the obligations under the principal contract by his own assets and goodwill.
2. A mortgage contract to be valid may have to be registered. A guarantee contract is valid after it has been legally concluded.
3. The mortgagor under a mortgage may be the obligor or a third party; but a guarantor must be a third party.
4. The mortgagee has a priority in repayment but an obligee under a guarantee is just an ordinary creditor of the obligor.

However, it seems that the mortgagee does not have a 'full property right'. His right is restrictive in that he is not entitled to possess, use and dispose of the mortgaged property during the currency of the mortgage contract. His right over the mortgaged property arises only when the obligor fails to perform his obligations under the principal contract.

The Law does not distinguish between a mortgage and a charge under the common law. As there is nothing similar as in China to the branch of English law known as equity, there are no provisions on the law relating to legal and equitable mortgages, and equity of redemption.

to perform his obligations, a mortgagee shall be entitled to priority in receiving compensation from the proceeds of an auction of the mortgaged real property in accordance with the law.

41 See 9 above, p44.

42 The subject matter of a property right must be a specific thing over which a person can exercise control to the exclusion of others. The Chinese concept of property rights is based on the civil law concept. It is a right to exercise exclusive control over a specific thing, an absolute right, and a right against the whole world. See *'The Principles of Science of Civil Law'*, China University of Political Science and Law Press (Beijing) 1991, 333-7.

## Mortgaged Property

The subject matter of a mortgage may be immovable property or movable property. Immovable property refers to land and attachments to land such as buildings and forestry trees. Movable property refers to property other than immovable property (Art 92). The following points should be noted:<sup>43</sup>

1. The subject matter under a mortgage must be property which the mortgagor is legally entitled to dispose of.<sup>44</sup> This requirement is satisfied if the mortgaged property is owned by the mortgagor, or can be disposed of by the mortgagor according to law, if the property belongs to the state. The following property may be mortgaged (Art 34):
  - a. Buildings<sup>45</sup> and other attachments to land owned by the mortgagor;
  - b. Machinery, transport equipment and other property owned by the mortgagor;
  - c. State-owned land use rights, buildings and other attachments to land, which the mortgagor is legally entitled to dispose of;<sup>46</sup>
  - d. State-owned machinery, transport equipment and other property, which the mortgagor is legally entitled to dispose of;
  - e. Land use rights pertaining to barren hills, dry river beds, mounds, beaches, etc, contracted out to the mortgagor;
  - f. Other property that may be mortgaged according to law.<sup>47</sup>
  
2. The mortgaged property must be property which can be legally transferred. There are some types of real property which, according to Article 37 of the Urban Real Property Law, cannot be legally transferred. For example, land use rights, where the conditions for the grant have not been complied with; real property which is subject to a restrictive order imposed by a people's court or by an administrative organ; real property the title to which is under

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43 See 9 above 125.

44 The right to dispose of the property includes the right to destroy, to transfer the ownership of, to possess and to use the property. See *The Chinese Legal Dictionary*, Jiang Ping (ed.), Jilin People's Publishing House 1991, 442.

45 There is no definition of 'buildings' in the PRC Law of Securities. But the Urban Real Property Law defines 'buildings' as meaning houses, other buildings and structures erected on land (Art 2).

46 Article 10 of the Constitution of the PRC ( adopted 4 December 1982, amended 1988 & 1993) provides: Land in the cities is owned by the state. Land in the rural and suburban areas is owned by the collectives except for those portions which belong to the state in accordance with the law; house sites and private plots of cropland and hilly land are also owned by the collectives. For an English translation of the Constitution, see CCH International, *China Laws for Foreign Business-Business Regulation*, ¶4-500(10). Land use rights may be granted by the State for a definite number of years to a land user by means of auction, tender or bilateral agreement (see Art 12, Urban Real Property Law).

47 This is a standard provision in Chinese legislation. 'According to law' in this context means according to law to be promulgated in future.

dispute; real property that has not been registered and for which no title certificate has been obtained in accordance with the law. In addition, Article 37 of the PRC Law of Securites provides:

The following property may not be mortgaged:

- a. Ownership of land.
  - b. Land use rights pertaining to collectively owned lands such as farmlands, house sites and lands and hills allotted for personal needs except for those listed in Articles 34 and 36.
  - c. Educational, medical and other public welfare facilities of non-profit-making organisations, such as schools, kindergartens, hospitals and other social organisations.
  - d. Property over which ownership, or property the right to the use of which, is unclear or is in dispute.
  - e. Property which is legally sealed, sequestered or controlled.
  - f. Other property that may not be mortgaged according to law.
3. The obligations secured by a mortgagor may not exceed the value of the mortgaged property. If the mortgaged property has a value which is in excess of the obligee's claim, it may be further mortgaged for a further debt not exceeding the balance (Art 35).
  4. If the mortgagor wants to mortgage the land use rights, he should also mortgage at the same time the buildings that are on the land. If he mortgages the buildings that stand on the land, he should also simultaneously mortgage the land use rights of the land occupied by such buildings.<sup>48</sup> Land use rights pertaining to township and village enterprises should not be mortgaged per se. Where the buildings of township and village enterprises are mortgaged, land use rights pertaining to land occupied by the buildings should be mortgaged at the same time (Art 36).<sup>49</sup>
  5. Mortgage rights should not be transferred separately from the obligee's claims or be used as security for other claims (Art 50).
  6. Mortgage rights shall be extinguished by the loss of the mortgaged property. Compensation obtained for such loss shall serve as mortgaged property (Art 58).
  7. The mortgage of real property should be handled on the strength of land use right certificates and building ownership certificates.<sup>50</sup>

### **The Mortgage Contract**

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48 See also Art 31 'Urban Real Property Law'.

49 See also Art 47 'Urban Real Property Law'.

50 See Art 48 'Urban Real Property Law'.

The mortgage contract must be in writing (Art 38) and should contain the following information:

1. The type of obligation and the amount of the principal debt secured.
2. The parties may agree to use the mortgaged property to secure a series of obligations within a certain period of time and up to a certain maximum amount (Arts 59-62).
3. The time limit for the obligor to perform the obligation.
4. The name, quantity, quality, state, location and ownership of, and use right to, the mortgaged property.
5. The scope of security covered by the mortgage.
6. Subject to the provisions in the contract, the amount secured should include the principal debt, interest, breach of contract damages, compensation damages and expenses incurred in realising the obligation (Art 46).
7. Other matters that the parties consider necessary to be included in the mortgage contract.

If the mortgage contract does not include all the above information, it may be amended. A contract which provides that legal ownership of the mortgaged property be transferred to the obligee where the time limit for the performance of the obligor's obligations has expired but the obligor has not yet performed the obligations is void to that extent (Art 40). There are no provisions in the Law obliging the mortgagee to provide the mortgagor with a copy of the principal contract before the formation of the mortgage contract, nor a copy of the mortgage contract after it has been signed.

### **Registration of Mortgaged Property**

Mortgages of certain types of property have to be registered. The parties to the mortgage must register the following mortgaged property with the relevant government departments and the mortgage contract takes place upon registration.<sup>51</sup>

1. Land use rights without any attachments: the land administration department that issues the land use right certificate.
2. Urban real estate or buildings of township and village enterprises: the authority designated by the local people's government.
3. Forestry trees: the forestry administration department.

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51 See Arts 41 & 42 PRC 'Law of Securities'.

4. Aircraft, ships and vehicles: departments in charge of the registration of means of transport.
5. Facilities and other movable property of an enterprise: the local industrial and commercial administration department where the property is located.

As regards mortgage of other types of property, registration is not compulsory<sup>52</sup> and the mortgage contract becomes effective on the date of signing. Registration of such mortgaged property is strongly advisable, because if the parties have not registered such property, their interests shall be defeasible by the claims of third parties (Art 43).

Article 54 provides that where the same property is mortgaged to two or more obligees, the proceeds from the auction or sale of the mortgaged property shall be used to settle claims in accordance with the following rules:

1. Where the mortgage contracts take effect upon registration, payment will be made according to the order of registration. Where the mortgages in question are registered at the same time, payment will be made according to the proportion of the obligations.
2. Where the mortgage contracts take effect on the date of signing and the mortgaged property has been registered, payment will be made according to para 1 above; where the mortgaged property is not registered, payment will be made according to the order of the time at which the contracts become effective. Where the contracts take effect on the same date, payment will be made according to the proportion of the obligations. With respect to payment, mortgaged property that has been registered shall have priority over mortgaged property that has not been registered.

To register a mortgaged property, the following documents or duplicates should be submitted to the relevant government departments:

1. The principal contract and the mortgage contract;
2. Certificates of ownership or of use rights pertaining to the mortgaged property (Art 44).

The information kept in the departments is available to the public for reading, copying or photocopying (Art 45).

### **Rights and Duties of Mortgagee and Mortgagor**

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52 If the parties want to register the mortgaged property, they should do so with the local notarial department (Art 43).

Article 53 of the Law provides that when the obligor fails to perform his obligations, the obligee (ie the mortgagee) may agree with the mortgagor to convert the mortgaged property to value or to auction or sell the property. But the legal ownership of the mortgaged property will not be transferred to the obligee because of the obligor's default (Art 40). If the obligee (mortgagee) and the mortgagor fail to reach any agreement, the mortgagee may sue the mortgagor in a people's court. Should there be a difference between the evaluated price or the proceeds from auction or sale of the mortgaged property and the amount of the obligee's claim, any excess should be returned to the mortgagor and any shortfall paid by the obligor (Art 53).

A third party that provides the security in the form of a mortgage for the obligor is entitled to compensation by the obligor following the realisation of the mortgagee's rights under the mortgage (Art 57).

Where mortgaged property is seized by a people's court because of the obligor's failure to perform his obligations at the expiration of the time for such performance, the mortgagee, as from the date of the seizure, is entitled to claim the natural benefits<sup>53</sup> and the legal benefits<sup>54</sup> that the mortgagor may enjoy from the mortgaged property. The mortgagee is not entitled to the legal benefits if he fails to notify the appropriate party of the seizure of the mortgaged property by the people's court (Art 47).

Article 48 provides that where a mortgagor mortgages property which is already leased out, he should inform the lessee in writing and the original lease agreement shall remain valid. The lessee's consent is not required for the mortgage to be valid. But what is the position if the lessee is not informed of the mortgage? The Law does not provide an answer for this question. Under normal circumstances, the validity of the lease should not be affected by the mortgage. It is suggested that the main purpose of Article 48 is to enable the lessee to pay the rent over to the mortgagee who has now become the owner of the property.<sup>55</sup> The difficulty with this interpretation is that during the currency of the mortgage contract, the mortgagee as such is not entitled to receive the rental from the lessee.

Article 49 provides, among other things, that any purported transfer of the mortgaged property (which has been registered) by the mortgagor is not valid unless the mortgagee is informed of the purported transfer and the transferee is informed of the fact that the property has been mortgaged. This emphasis on disclosure of information is interesting, as the common law requires *consent* of the mortgagee or the *authority* of the court for any assignment or disposal of mortgaged property by the mortgagor. It is also

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53 There is no definition of 'natural benefits'. But it is obvious that they include such things as wheat and rice in the fields and fruit from the trees.

54 There is no definition of 'legal benefits'. But it is obvious that they include rental income from buildings.

55 See 9 above, p66.

provided that where the purchase price of the mortgaged property to be transferred is clearly lower than the property's value, the mortgagee may request that the mortgagor provide a corresponding security; and if it is not so provided, the mortgaged property shall not be transferred. The proceeds from the transfer of the mortgaged property shall be used to pay the mortgage debt in advance or will, upon agreement with the mortgagee, be deposited with a third party. Any portion in excess of the amount of the obligation shall be kept by the mortgagor. If the purchase price is insufficient to satisfy the obligee's claim, the obligor shall pay the shortfall.

Where an act<sup>56</sup> of the mortgagor results in diminution in value of the mortgaged property, the mortgagee is entitled to request that the mortgagor stop such act, restore the value of the mortgaged property, or provide security equal to the reduction in value. If the diminution in value of the mortgaged property is not due to the mortgagor's fault,<sup>57</sup> the mortgagee may only require the mortgagor to provide a security within the scope of the compensation received by the mortgagor for the loss. That part of the mortgaged property which has not suffered a reduction in value shall remain as security for the obligee's claim (Art 51).

## **Pledge**

### **Definition**

According to Article 63 of the Law, a pledge is created when an obligor or a third party transfers possession of his movable property to the pledgee as security for the fulfilment of the obligations under the principal contract. When the obligor does not fulfil his obligations, the obligee is entitled to convert the mortgaged property to value, to auction or to sell the property. This definition is less than satisfactory, because the subject matter of a pledge is not confined to movable property. Certain 'rights' may also be pledged. Article 75 provides that the following rights may be pledged:

1. Bills of exchange, cheques, promissory notes, bonds, certificate of deposits, warehouse receipts, bills of lading;
2. Legally transferable shares and share certificates;
3. Legally transferable trademark rights, patent rights, copyright and other intellectual property rights;
4. Other rights that may be pledged according to the law.

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56 The Law is silent as to the nature of the 'act'. It is suggested that there are positive acts such as cutting down trees and demolishing buildings, and negative acts such as failure to repair or maintain dangerous buildings. See 9 above, 68-69.

57 The Law does not define 'fault'. If the value of the mortgaged property is reduced as a result of a natural disaster (such as an earthquake or a flood, that is not caused by human beings), a fire, or theft, there will not be any fault on the part of the mortgagor. See 56 above.

The obligee's rights under the pledge and under the principal contract co-exist. The pledge shall be extinguished with the discharge of the obligations under the principal contract (Art 74).

### **Differences Between Mortgage and Pledge**

There are certain significant differences between a mortgage and a pledge.<sup>58</sup> First, a mortgage does not involve transfer of possession of the mortgaged property, but a pledge of movable property involves the transfer of the possession of the pledged property from the pledgor to the pledgee.<sup>59</sup> Second, mortgage of property usually requires registration, but no registration is required for a pledge of movable property. As regards pledge of shares, share certificates, and intellectual property rights, the Law requires registration of the pledge with the relevant government departments (Art 78 & 79). Third, the subject matter of a mortgage may be movable or real property, but the subject matter of a pledge is movable property or a certain property right (such as an intellectual property right).

### **The Pledge Contract**

The pledge contract must be in writing and takes effect from the date when possession of the pledged property is transferred from the pledgor to the pledgee (Art 64). It should include the following terms (Art 65):

1. The type of obligation and the amount of the principal debt secured.
2. The time limit for the obligor to perform the obligation.
3. The name, quantity, quality and state of the pledged property.
4. The scope of security covered by the pledge.

Subject to the provisions in the contract, the amount secured should include the principal debt, interest, breach of contract damages, compensation damages, charges for the custody of the pledged property and expenses incurred in realising the obligation (Art 67).

5. The time for the transfer of possession of the pledged property.
6. Other matters that the parties consider necessary to be included in the pledge contract.

If the pledge contract does not include all the above information, it may be amended. A contract which provides that legal ownership of the

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58 See 9 above, 44-45.

59 Where bills of exchange, cheques, promissory notes, bonds, certificates of deposits, warehouse receipts and bills of lading are pledged, the documents of title should be transferred to the pledgee. The pledge contract takes effect from the date of the transfer of the title documents (Art 76).

pledged property be transferred to the pledgee where the time limit for the performance of the obligor's obligation has expired but the pledgee has not yet been paid off is void to that extent (Art 66).

### **Rights and Duties of Pledgor and Pledgee**

The law specifies the following rights and duties in various sections:

1. Subject to the provisions in the pledge contract, a pledgee is entitled to the natural and legal benefits produced by the pledged property (Art 68).<sup>60</sup>
2. A pledgee is responsible for the proper custody of the pledged property and will be civilly liable for breach of this duty (Art 69).
3. Where there is a possibility of damage to, or reduction in the value of, the pledged property which is serious enough to jeopardise the rights of the pledgee, the pledgee may request that the pledgor provide a corresponding security. Where the pledgor fails to provide such security, the pledgee may auction or sell the pledged property and, subject to an agreement with the pledgor, use the proceeds from the auction or sale to pay the obligee's claim in advance or deposit the proceeds with a third party (Art 70).
4. Where the obligor has performed his obligations, or where the pledgor has settled the obligee's claims before the expiration of the time limit for the performance of the obligor's obligations, the pledgee should return the pledged property to the pledgor (Art 71, par 1).
5. Where the time limit for performance of the obligor's obligations has expired and the pledgee has not been paid, the pledgee may agree with the pledgor to convert the pledged property to value or to auction or sell the property (Art 71, par 2). If there is a difference between the valuation of the pledged property, or proceeds from auction or sale of the property, and the obligee's claims, any excess should be returned to the pledgor and any shortfall be paid by the obligor (Art 71, par 3).
6. A third party that provides the pledge for the obligor is entitled to compensation by the obligor after the pledgee has realised his rights under the pledge (Art 72).
7. The pledgee's rights shall be extinguished by the loss of the pledged property. Compensation obtained for such loss shall serve as pledged property (Art 73).

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60 See 53 and 54 above.

8. Where bills of exchange, cheques, promissory notes, bonds, certificates of deposit, warehouse receipts or bills of lading that bear redemption or delivery dates are pledged and the redemption or delivery dates are due prior to the expiration of the time limit for repayment of the debt, the pledgee may redeem or take delivery of the goods prior to the expiration of the time limit for repayment of the debt. Furthermore, upon agreement with the pledgor, the pledgee may employ the money redeemed or the goods taken delivery of to satisfy in advance his claim as an obligee, or deposit the money or goods with a third party (Art 77).<sup>61</sup>
9. Subject to an agreement to the contrary, a pledgor is not allowed to transfer shares and intellectual property rights that are subject to a pledge to another person, nor can he allow other people to use the intellectual property rights (Art 78 & 80).

### **Lien**

There are only seven articles ( Art 82-88) relating to liens. Like under the common law, a lien is a right of an obligee to retain the movable goods of an obligor as security for the performance of an obligation. The right is 'possessory' in nature. But unlike the common law, the goods in question are confined to goods which are the subject matter of a storage contract, transport contract or processing contract (Art 84, par 1),<sup>62</sup> and the obligee may convert the property to value, auction or sell the property under the contract to satisfy his claims (Art 82). The parties may specify in the contract the items over which a lien may not be exercised (Art 84, par 3). The legal nature of a lien can be further explained by comparison with mortgage of goods and pledge.

Mortgage of goods is based on the existence of a mortgage contract and it does not involve transfer of possession of the goods to the mortgagee. A lien is created by the Law and arises when the obligee already has actual lawful possession of the goods of the obligor under a storage contract, transport contract or processing contract, and the obligee's right to retain the goods lasts until an obligation is performed; no agreement is necessary between the obligor and obligee for a lien to arise. The subject matter of a mortgage may be movable property or real property, but the subject matter of a lien must be movable property. A mortgagor may be the obligor or a third party, but the lienor must be the obligor under the contract.

Like a pledge, a lien is a security which is characterised by the possession of goods. However, whereas a pledge arises from a pledge contract, a lien arises by operation of law. The subject matter of a pledge

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61 The translation is mainly based on the translation of the CCH 'China Laws for Foreign Business-Business Regulation' ¶5-605.

62 Article 84, par 2. provides that 'the provisions of the preceding paragraph shall apply to other contracts that may be subject to lien according to the law'. 'According to law' in this context probably means 'according to law to be promulgated in future.'

may be movable goods or certain property rights (such as intellectual property rights), the subject matter of a lien must be goods under a storage contract, transport contract or processing contract. A lien but not a pledge shall be extinguished if the obligor provides an alternative security which is accepted by the obligee (Art 88).

The lienee is obliged to take proper custody of the property over which a lien is taken, and can be sued by the lienor for breach of this duty of care (Art 86).

Article 87 provides that the obligor and the obligee should stipulate in the contract that after the obligee has taken a lien over the property, the obligor should perform his obligations within no less than two months. Where there are no such stipulations in the contract, the obligee should, after taking a lien over the property, set a time limit of no less than two months for the obligor to perform his obligations and notify the obligor accordingly. Where the obligor fails to perform his obligations within the specified time limit, the obligee may, upon agreement with the obligor, convert the property to value or be compensated with the proceeds acquired from auction or sale of the property in accordance with the law.<sup>63</sup>

A lien shall be extinguished when the obligation under the contract is discharged; or when the obligor provides an alternative security which is accepted by the obligee (Art 88).

### **Deposit**

There are only three articles (Art 89-91) on deposits. Parties may agree in writing that one party pay the other party a deposit as a security for an obligation. The amount of the deposit should not exceed 20 per cent of the value of the subject matter of the principal contract. After the obligor performs his obligation, the deposit must be deducted from the price or returned. Where the party who gives the deposit does not perform his obligation, he does not have the right to request the return of the deposit; if the party who receives the deposit does not perform the obligation, he must return twice the amount of the deposit.

### **Conclusion**

The PRC Law of Securities is a most important piece of securities legislation which is meant to elaborate on Article 89 of the General Principles of Civil Law. It clearly distinguishes between different types of securities; in particular, it differentiates between a mortgage and a pledge. It provides answers to questions such as who is legally competent to provide securities, what kinds of property may be the subject matter of a pledge, mortgage, or lien, what the rights and duties of the parties to a

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63 This translation is based on CCH 'China Laws for Foreign Business-Business Regulation' ¶5-606.

security contract are and what the proper procedure for creating a security interest.

The Law provides the legal basis for the People's Bank of China to make regulations for the administration of the provision of securities to foreign entities by domestic financial institutions. On 25 September 1996, the People's Bank of China promulgated the Administration of the Provision of Securities to Foreign Entities by Domestic Institutions Inside China Procedures.<sup>64</sup> These Procedures are formulated in order to promote foreign economic and technological co-operation, support foreign trade development, promote the export of labour, introduce foreign advanced technology, equipment and capital, facilitate the development of financial activities as well as to standardize and strengthen the administration of the provision of securities to foreign entities (Art 1).

The Law has grown out of China opening up to the outside world since 1979 and the rapid development of the Chinese economy over the past ten years. Undoubtedly, the Law has a lot of Chinese characteristics. But it is equally clear that many of the concepts actually spring from the common law system, generally foreign to businessmen, party and government officials, lawyers and judges in China. To some extent, there is justification for saying that the Law is hybrid legislation in the sense that some provisions are based on the civil law concepts of 'property rights', 'personal rights' and 'obligations', while others are based on the common law principles, for example, of mortgage, pledge, guarantee and lien. Many of the senior judges and lawyers in China receive their legal training under the Chinese socialist legal system, which was significantly influenced by the former Soviet socialist legal system. It will be interesting to see how Chinese lawyers and judges will interpret and apply the provisions in this hybrid legislation to the facts of the cases before them.

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64 For an English translation of the Securities Provision Procedures, see *China Law & Practice* Dec96/Jan 97, 43-48. The Procedures came into effect on 1 October 1996. The State Administration of Exchange Control shall be responsible for the interpretation of these Procedures (Art 19).